INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	3
Statement	3
Argument	9
Conclusion	14
Appendix	15

CITATIONS

Cases:

Bank of America Nat. Trust & Sav. Ass'n v. *United States*, 168 F. 2d 399, certiorari denied, 335 U. S. 827	10
Commissioner v. *Kennedy Laund. Co.*, 133 F. 2d 660, certiorari denied, 319 U. S. 770	10
Pittsburgh Brewing Co. v. *Commissioner*, 107 F. 2d 155	13, 14
Repplier Coal Co. v. *Commissioner*, 140 F. 2d 554, certiorari denied 323 U. S. 736	10, 14
Virginian Hotel Co. v. *Helvering*, 319 U. S. 523, rehearing denied, 320 U. S. 810	9, 10, 11, 12, 13, 14

Statutes:

Revenue Act of 1938, c. 289, 52 Stat. 447:

Sec. 23	15
Sec. 113	9, 16
Sec. 114	16

Miscellaneous:

Treasury Regulations 101, Art. 113(b)-1	17

In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 628

COMMERCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The District Court rendered no opinion but entered findings of fact and conclusions of law (R. 34-37) which are unreported. The opinion of the Court of Appeals (R. 42-47) is reported in 171 F. 2d 189.

JURISDICTION

The judgment of the Court of Appeals was entered on December 7, 1948 (R. 48). The petition for a writ of certiorari was filed on March 5, 1949.

The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

The Commissioner of Internal Revenue adjusted the depreciation rates claimed by the owners of the Texas State Hotel properties and the Krupp and Tuffly Building for 1929, 1930 and 1931, pursuant to revenue agent reports and conferences relating to such years. No corresponding adjustments were made in the depreciation claimed on the Texas State Hotel properties for the years 1932, 1933 and 1935, and the Krupp and Tuffly Building for the years 1932, 1933, 1934 and 1935. The tax returns of the owners for these latter years were accepted by the Commissioner as filed.

The question here presented is whether, in determining the "adjusted basis" of the properties for the purpose of computing depreciation on the Texas State Hotel properties for the taxable periods in suit and for the purpose of computing the deductible loss from the sale of the Krupp and Tuffly Building on May 31, 1938, the full amount of the deductions taken as depreciation in the years in which the returns were accepted as filed should be subtracted from the cost, or only an amount equal to the depreciation for such years computed at the rates used by the Commissioner for 1929, 1930 and 1931. The answer depends upon whether the deductions for depreciation claimed in the owners' tax returns which were accepted as filed were

"allowed" within the meaning of Section 113 (b)(1)(B) of the Revenue Act of 1938.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix, *infra*, pp. 15-18.

STATEMENT

This is an action brought against the United States by the Commerce Company (herein sometimes referred to as the taxpayer) for the recovery of income tax paid. For the period January 1, 1938, to September 23, 1938, the taxes were assessed to and collected from the taxpayer as transferee of State Properties Corporation. The taxes were paid by the taxpayer on its own account for the fiscal year June 1, 1938 to May 31, 1939. (R. 14.) All facts were stipulated and the only question involved is with the respect to the computation of the adjusted basis on the Texas State Hotel properties and the Krupp and Tuffly Building for the periods in suit. The Texas State Hotel properties include ten individual items (R. 29, 30, 31) on each of which depreciation was allowed in the years 1929 through 1937, at rates peculiarly applicable to each item. Four separate items were similarly treated in connection with the Krupp and Tuffly Building. (R. 32.)

In the following statement, for the sake of clarity, reference to precise figures with respect to cost and depreciation has been omitted. The

figures are set forth in the stipulation of facts (R. 29-33).

Texas State Hotel Properties.—The Texas State Hotel properties were first placed in use in 1929. They were owned and operated by the Theo Development Company from 1929, to December 31, 1931, when the name of the company was changed by charter amendment to Texas State Company. The Texas State Company owned and operated the Texas State Hotel properties from December 31, 1931, to September 30, 1936, when they were transferred to State Properties Corporation. The transfer to State Properties Corporation was a tax-free transaction. On July 1, 1938, the State Properties Corporation transferred all of its assets and liabilities to the taxpayer through a tax-free reorganization. (R. 15, 19.) Inasmuch as the transfer to State Properties Corporation and the reorganization whereby the taxpayer acquired the assets of State Properties Corporation were tax-free transactions, the taxpayer acquired the depreciation basis of the prior owners.

The owners of the Texas State Hotel properties filed income tax returns for each year from 1929, through 1937, and claimed deductions for depreciation on such properties each year (R. 19-22). The depreciation claimed for the years 1929, 1930 and 1931, was partially disallowed by the Commissioner of Internal Revenue. This action was taken pursuant to a conference report dated August 29, 1936, it having been agreed that the useful life of

the properties had been underestimated in the returns for these years and that the depreciation rates used in computing the deductions claimed in the returns should be adjusted accordingly. (R. 19-20.)

Pursuant to subsequent revenue agent reports, a part of the deductions for depreciation claimed for the year 1934, the taxable periods in 1936 and the year 1937, was also disallowed. The depreciation allowed for 1934, and the taxable periods in 1936, was recomputed by employing the rates finally used by the Commissioner for 1929, 1930 and 1931. For the year 1937, the same rates were used on all items except the building and the elevators. It was decided that the building and elevators had a longer useful life than previously estimated and an appropriate change was made with respect to their depreciation rates. (R. 21-23.)

The Commissioner of Internal Revenue accepted the income tax returns of the owners of the properties for 1932, 1933 and 1935, as filed, and made no challenge to the deductions for depreciation taken in them. The depreciation allowed in these returns was at a higher rate than was finally allowed for 1929, 1930 and 1931. During the years 1932, 1933 and 1935, the returns disclosed a net loss in excess of the difference between the amount of depreciation claimed and the amount allowable for those years at the rates finally used by the

Commissioner for the years 1929, 1930 and 1931. (R. 20-22.)

In determining the adjusted basis for computing depreciation on the Texas State Hotel properties for the period involved in this suit, beginning January 1, 1938, the Commissioner of Internal Revenue subtracted from the cost of the properties the full amount of the depreciation claimed in the returns accepted as filed for the years 1932, 1933 and 1935, as well as the amount allowed pursuant to the various revenue agent and conference reports for the other years in which the building had been in use. The adjusted basis of each property item thus determined was then divided by the estimated number of years of remaining useful life of the item to determine the depreciation deduction for the taxable periods here involved. (R. 30.)

The taxpayer contends that the Commissioner of Internal Revenue erred with respect to the years in suit in subtracting from the cost of the Texas State Hotel properties the full amount of depreciation claimed in the tax returns of the owners for the years 1932, 1933 and 1935. It contends that only a sum equal to the depreciation allowable for those years at the rates finally used for 1929, 1930 and 1931, should have been subtracted. The District Court and the Court of Appeals sustained the Commissioner's action. (R. 35, 47.)

Krupp and Tuffly Building.—Substantially the same problem arises with respect to the Krupp and Tuffly Building. This building was erected

by the Hewitt Construction Company in 1929, a subsidiary of Jesse H. Jones & Company, and was transferred upon completion to the Southern Loan and Investment Company, then also a subsidiary of Jesse H. Jones & Company. This transfer was a tax-free transaction. On December 31, 1932, the building was transferred to Hippodrome Building and Amusement Company and this was a tax-free transaction. On September 30, 1936, the name of the Hippodrome Building and Amusement Company was changed to State Properties Corporation. (R. 24.) As pointed out above, the taxpayer is a successor through a tax-free reorganization of the assets and liabilities of the State Properties Corporation. Inasmuch as the transfers of the building were tax-free transactions, the State Properties Corporation, of which the taxpayer is transferee, acquired the depreciation basis of the former owners.

The total cost of the Krupp and Tuffly Building, including additions, was $211,799.50 (R. 32). It was sold on May 31, 1938, by State Properties Corporation to the Southern Loan and Investment Company for the sum of $152,348.93. This was a taxable transaction. (R. 27-28.)

From 1929 through 1937, the owners of the building filed income tax returns and therein claimed deductions for depreciation on the building. The rates used in the returns were the same for each year. The Commissioner of Internal Revenue

adjusted the amounts of depreciation claimed in the returns for the years 1929, 1930 and 1931, pursuant to a conference report dated July 13, 1936, and allowed only a part of the depreciation claimed. The returns for all other years were accepted by the Commissioner as filed. (R. 24-26.)

In computing the loss from the sale of the Krupp and Tuffly Building, the Commissioner deducted from the cost of $211,799.50 the amount of the depreciation allowed for the years 1929, 1930 and 1931, the full amount claimed in the income tax returns filed for the years 1932 through 1937, and the amount claimed for the period January 1, 1938, to the date of the sale, May 31, 1938. The total amount of such depreciation was $55,488.02. (R. 32.) The difference between this amount and the cost of the building is $156,311.48, and this figure was taken as the adjusted basis. The difference between this figure of $156,311.48 and the sales price of $152,348.93 is $3,962.55, and this was the amount allowed by the Commissioner as a deductible loss. (R. 33.)

The taxpayer contends that the Commissioner erred in deducting from the cost the full amount of the depreciation claimed in the tax returns of the owners for the years 1932, 1933, 1934 and 1935, years in which the owners' income tax returns disclosed net losses (R. 20, 25-26). It is of the view that the Commissioner should have subtracted in respect of these years only a sum equal to the depreciation allowable at the rates finally used by

the Commissioner for the years 1929, 1930 and 1931. Both the District Court and the Court of Appeals sustained the action of the Commissioner. (R. 36, 47.)

ARGUMENT

1. The controlling statute is Section 113 (b)(1)-(B) of the Revenue Act of 1938, Appendix, *infra*, p. 16, which provides that the "adjusted basis" for computing gain or loss (and depreciation under other statutory provisions) shall be determined by making proper adjustments for exhaustion, wear and tear, and obsolescence in prior years "to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws." In *Virginian Hotel Co.* v. *Helvering,* 319 U. S. 523, rehearing denied, 320 U. S. 810, the petitioner claimed deductions for depreciation in its returns for 1927 through 1937 at rates in excess of those determined for 1938. For the years 1931 through 1936, the petitioner had net losses in excess of the amounts of depreciation claimed as deductions. The petitioner contended that its adjusted basis for 1938 should be computed by subtracting from the cost, in respect of the years 1931 through 1936, only an amount equal to the deduction allowable for those years at the rates used for 1938, because it had received no tax benefit from the excessive deductions. This Court held that under Section 113 (b)-(1)(B), excessive amounts deducted from gross income in prior years as depreciation should be deducted from the cost of the property in question in

determining the adjusted basis of the property for the current taxable year even though, in the earlier years, no tax benefit was realized by the taxpayer from such excessive deductions.[1]

The *Virginian Hotel* case was in no material respect different from the one here presented. In both cases, the Revenue Act of 1938 was the controlling statute. The taxpayer in each case filed, for years in which no net income was realized, tax returns in which amounts were deducted as depreciation on the properties involved in excess of the rates finally determined and agreed upon with the Commissioner of Internal Revenue in respect of other years. These returns were accepted as filed and no challenge was made of the deductions for depreciation therein made. In each case, in computing the adjusted basis for the tax periods in 1938, the Commissioner subtracted from the cost of the properties the full amount of the depreciation claimed in the accepted returns and allowed depreciation (and here the loss on the sale of the Krupp and Tuffly Building) in accordance with the adjusted basis so computed. In each case, the taxpayer contended that the cost basis should be reduced with respect to the loss years only by an amount equal to a deduction allowable at rates agreed upon by the taxpayer

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[1] Certiorari has since been denied in the following cases presenting this issue: *Commissioner* v. *Kennedy Laund. Co.*, 133 F. 2d 660 (C.A. 7th), certiorari denied, 319 U.S. 770; *Repplier Coal Co.* v. *Commissioner*, 140 F. 2d 554 (C.A. 3d), certiorari denied, 323 U.S. 736; *Bank of America Nat. Trust & Sav. Ass'n* v. *United States*, 168 F. 2d 399 (C.A. 9th), certiorari denied, 335 U.S. 827.

and the Commissioner in connection with other years and that the difference between such amounts and the amounts claimed in the returns should be restored to the adjusted basis for 1938. The action taken by the Commissioner on the tax returns for the loss years and the contentions of the taxpayers with respect to them are, therefore, the same in both cases.

The only difference between the underlying facts in the two cases is with respect to the action taken by the Commissioner on the returns for prior years in which net income was reported. In *Virginian Hotel Co.* v. *Helvering,* 319 U. S. 523, rehearing denied, 320 U. S. 810, the Commissioner accepted as filed the returns for prior years in which net income was reported and did not challenge the deductions for depreciation taken in them. The adjusted basis for 1938 was computed by subtracting from the cost the full amount claimed in the returns for such years. In the instant case, the Commissioner made adjustments of the depreciation claimed on the Texas State Hotel properties for 1929, 1930, 1931, 1934, 1936 and 1937, and on the Krupp and Tuffly Building for 1929, 1930 and 1931. In computing the adjusted basis for 1938, the amounts allowed as depreciation for these years in accordance with the adjustments so made were subtracted from the cost.

The taxpayer does not here challenge the correctness of the adjustments made by the Commissioner in respect of the depreciation rates for prior years

in which net income was received or the correctness of the Commissioner's action in subtracting from the cost the revised amounts for those years for the purpose of computing the adjusted basis. However, the taxpayer argues that the rule of the *Virginian Hotel* case is inapplicable because the depreciation rates were here adjusted for 1929, 1930 and 1931, years prior to the loss years, whereas in the *Virginian Hotel* case the rate adjustments were made for 1938, a year subsequent to the loss years.

This factual difference obviously does not affect the question whether the depreciation claimed in the returns accepted by the Commissioner as filed for the loss years was "allowed" within the meaning of Section 113 (b)(1)(B). There is nothing in the statute to suggest that this difference between the two cases dictates or even permits a different result. The revenue laws impose no more obligation upon the Commissioner to make audits and corresponding corrections in returns for net loss years subsequent to the years for which audits are made than it does in respect of returns for prior years. The taxpayer suggests no concrete reason stated in the statute, its language or its legislative history, which would cause the result in this case to be different from that in the *Virginian Hotel* case. The taxpayer's general plea that this Court develop some theory or another to lift it "out of a mire of statutory words" (Pet. 7) indicates that it recognizes that no such reason exists.

That the Commissioner's action with respect to the return for one taxable year is not determinative of whether a deduction for depreciation has been allowed in another is shown by the language of this Court in *Virginian Hotel Co.* v. *Helvering,* 319 U. S. 523, rehearing denied, 320 U. S. 810. After explaining the purpose of Section 113 (b)-(1)(B), this Court said (p. 527):

> Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are "allowed," since tax liability is then determined on the basis of the returns.
> * * *

From the foregoing, it seems apparent that the court below was correct in its conclusion that the instant case is controlled by the decision of this Court in the *Virginian Hotel* case and that the case was correctly decided.

2. There is no merit in the taxpayer's contention (Pet. 8) that a writ of certiorari should be granted in the instant case because of a conflict with *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. 2d 155 (C.A. 3d). If, as the taxpayer states (Pet. 8), its "facts are like the facts of the *Pittsburgh Brewing* case," this Court has, in effect, already upheld the correctness of the decision below. For, in its opinion in the *Virginian Hotel* case (319 U. S. at 525),

this Court stated that it had granted certiorari "because of a conflict between the decision below and *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. 2d 155, decided by the Circuit Court of Appeals for the Third Circuit." The conflict was resolved by rejecting the rule announced in the *Pittsburgh Brewing* case. As pointed out in the quotation from *Repplier Coal Co.* v. *Commissioner,* 140 F. 2d 554, 558 (C.A. 3d), in the opinion below in the instant case (R. 46), the decision in the *Pittsburgh Brewing Co.* case "was in effect overruled" by this Court in the *Virginian Hotel* case. And if the facts in this case differ materially from those involved in the *Pittsburgh Brewing* case, there is no conflict.

CONCLUSION

The decision below is correct. It is in accord with the decision of this Court in *Virginian Hotel Co.* v. *Helvering, supra.* It involves no conflict which has not previously been resolved. The petition for a writ of certiorari should, therefore, be denied.

Respectfully submitted,

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APRIL, 1949.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(i) *Basis for Determining Loss.*—The basis for determining the amount of deduction for losses sustained, to be allowed under subsection (e) or (f), and for bad debts, to be allowed under subsection (k), shall be the adjusted basis provided in section 113 (b) for determining the loss from the sale or other disposition of property.

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) * * * The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 113(b)-1. *Adjusted basis: General rule.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, is the cost of such property or, in the case of such property as is described in paragraphs (1) to (18), inclusive, of section 113(a), the basis therein provided, adjusted to the extent provided in section 113 (b).
>
> The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *
>
> * * * * *
>
> The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect of any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under the Revenue Act of 1938 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determina-

tion of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. * * *

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